Was the Mona Lisa Painted with a Roller? (4/10/14)

We will explore "income distribution" a bit differently than the "herd", and expose its economic implications.

As more people get pushed toward the lower 50%, there are less discretionary dollars to propel national growth.

Is it any wonder that Federal Reserve policies have fallen short?

While there has been ongoing debate about how much their policies have actually created jobs, there can be no debate as to whether or not they can affect what those jobs pay.

It has become nearly impossible to turn on the TV or pick up a newspaper without reading a story about income inequality in America. At RSW, we commented on this subject in the first quarter of 2011 and now feel that it is time for a "re-rack". Most often, income inequality is a topic of political debate, but we have never felt that this space was the appropriate forum for politics. Therefore, we will only add our two cents to the discussion in terms of its impact on our nation's economic health.

No one should delude themselves into thinking that there are any silver bullets for curing what ails the American economy. It is a marvelously complex and vibrant machine with many moving parts, but it is operated by humans so the inherent possibilities of accidents should come with that reality. With that said, as long as we remain an economy whose engine is 70% fueled by consumer spending, it is appropriate for discussions to be focused squarely on income levels. To the extent, however, that income inequality mostly refers to the chasm between the richest and the poorest, the narrative partly misses the mark. The heart of the problem does not lie in the distance between the highest point and the lowest, but rather in the surprising percentage of Americans that reside closer to the low point than the high. To this end, we will explore "income distribution" a bit differently than the "herd" and expose its economic implications.

Please indulge us for a moment, as we illustrate two radically different types of societies. Since we are exaggerating our illustration, let's call the first a "Utopian Economy" and the second a "Dystopian Economy".

Utopian	Dystopian
1% mega wealthy	1% mega wealthy
1% very wealthy	1% very wealthy
1% very comfortable plus	1% very comfortable plus
2% very comfortable	2% very comfortable
15% very comfortable minus	30% only enough for basics
60% pay bills, educate kids +one family vacation	30% right at the poverty line
15% a little less than above	35% extremely poor
5% poverty	
100%	100%

After reviewing the above, we don't believe you need a doctorate in economics to forecast which society would experience a better rate of growth. We can assume that the society with the largest pool of individuals that barely have enough dollars to survive will exhibit the lower growth rate. Additionally, that same society will see a vast amount of income controlled by those at the "top", where less of their earned dollars will probably be spent.

Let's dispense with further hypothetical hyperbole, and discuss where we are in the US today.

- In 2012, according to the Census Bureau, 20% of households were trying to survive on $11,490 or less (Federal poverty guidelines for 2013 are $19,790 for a family of 3).
- 10% of households fit the description of near poor (150% of poverty level) and another 10% were barely above that.
- 20% more of our households in the middle quintile (average earnings of $51,179) can barely meet what we can call basic needs.

50% of the population **cannot** *or* **can barely** meet basic needs.

Furthermore, we often hear pundits and politicians talk about the shrinking take home pay for the "average family". Since averages are sometimes misleading, this statistic also misses the mark. After all, there is a vast difference between the income levels of those at the top, compared to those at the bottom. In fact, from the peak wage years, the average income of families in the bottom half of our society has contracted at nearly twice the rate as those in the top half. The Federal Reserve has been taking note, and by its own admission has been disappointed in the ability of its policies to help "Main Street" as much as it had hoped. This is not surprising though, as the policy tools that are available to the Fed cannot be targeted to assist a specific class of people. In essence, the Fed is attempting to use a paint roller to paint the Mona Lisa. They simply lack the brushes to perform the intricate work. While there has been constant debate about how much their policies actually created jobs, there can be no debate whether or not they succeeded in boosting the level of overall compensation.

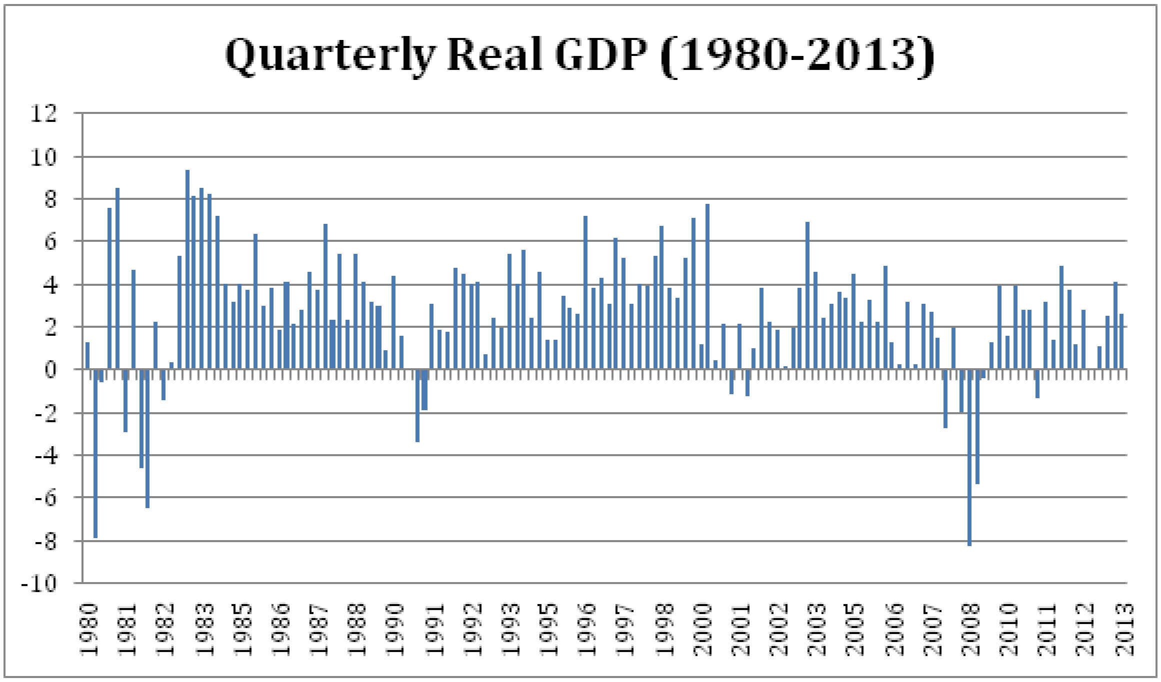
You should now have the answers to the following questions:

- Do we seem closer to the **Utopian** or the **Dystopian** economy?
- Is it any wonder that Federal Reserve policies have fallen short?
- If individuals can barely afford basic necessities, do they have the propensity to borrow or spend?
- Can the Fed really change the behavior of those "living on the edge" with monetary policy?

Answer Key: Dystopian and NO

So, what brings us to this point in time? This one is for us to answer. Many of our supporters have been asking us the same question for years: "When almost everyone, including the Fed, has called for higher growth rates going forward, why does RSW stick with a forecast that calls for an annual GDP to remain under 2%?" The tongue-in-cheek reply would be: Given the Fed's overly optimistic growth forecast over the last several years, just knock off 1% from their guess and you will be "closer to the pin". After all, the trend is your friend!

On a more serious note, we have consistently stated that our nation's problems and challenges are structural in nature, not cyclical. To support the theory, over the last seven years, we have addressed many forces, as we do here, that are likely "bigger than the Fed". Perhaps, a picture is truly worth a thousand words. Please see below for a graph detailing the Real Gross Domestic Product (the output of goods and services after inflation) of the United States since 1980. As you will note, each expansionary period has produced a weaker set of "output" than the period before.



Is this the picture for an economy that is just going through a normal cyclical downturn?

Where the Muni Bonds Are Not

The municipal bond market posted solid returns during the first quarter amidst the backdrop of a reduced supply of new issues, and relative calm in the Treasury bond market.

In our "2014 Fixed Income Market Outlook" we stated that we would not be surprised if new issue municipal volume "fell by as much as $100 billion during the course of 2014". If the start of the year-to-date is any indication of what is to come (or not to come), then this projection appears to be on course.
Consider the following:

- For the first 3 months of the year, new issue volume is 26% (or $22 billion), lower than the same period last year. The magnitude of this decline is even more pronounced when you consider that the first quarter is typically, by far, the lowest point of issuance during the course of any given year.

- Several states experienced extreme declines in new issuance. Namely, Connecticut (-35%), New Jersey (-77%), New York (-20%) and California (-40%).

- The impetus for the decline is the 52% reduction in refunding volume during this period. Barring any significant decline in rates, we expect this trend will continue.

- During this same period, the par value of bond redemptions and maturities (reported to be just under $70 billion) dwarfed new issuance by approximately $10 billion. While this contributed to relatively strong municipal sector performance, it made finding attractively structured bonds more challenging.

- As income tax season arrives, the municipal bond market, on average, tends to "cheapen". However, this seasonal pick up in yield, thus far, has been muted as investor demand outstripped "tax selling" and new issuance.

- Barring any disruptions caused by rising Treasury bond yields, the window for volatility in the municipal bond market is only half-open. This is because June, July and August, is by far the annual high season for investors receiving cash flow from maturing bonds, redemptions and coupon payments.

- We expect the normal seasonal pattern to run its course, whereby, the investor reinvestment of their proceeds surpasses the level of new issue supply.

Puerto Rico's $3.5 Billion Bond Sale

Puerto Rico grabbed its share of significant headlines with its March sale of $3.5 billion of general obligation bonds. Many "talking heads" and pundits lauded the Commonwealth for its successful sale despite across the board downgrades to below investment grade with negative outlooks. Success, however, is relative and came at a sizeable cost - bonds due in 2035 priced to yield 8.727% tax-exempt.

In our opinion, we define "success" as Puerto Rico gaining market access ***regardless of cost.*** While Puerto Rico has taken various steps to address fiscal ills, the problems are long standing, systemic and may prove to be difficult to resolve without future debt restructurings and/or moratoriums.

Consider the following bullet points, amongst many others, as listed in the opening pages of the Commonwealth's Official Statement under "RISK FACTORS":

- *The Commonwealth may be unable to honor its obligations to pay debt service on the Bonds.*

- *The Commonwealth may not be able to make the necessary General Fund budget adjustments to pay interest on the Bonds.*

Using long-term bond financing to finance existing deficits, and to provide much needed immediate liquidity, including the "rolling over" of various short-term obligations. In short, the Commonwealth was forced to borrow long, cost notwithstanding, to fund immediate cash needs. Puerto Rico's tax-supported debt increased by 49%, with deficit financing being a significant factor from fiscal 2009 to 2013.

This bond sale was bought, in large measure, by various "non-traditional" buyers, including hedge funds and various "crossover"(not typically municipal investors) institutional buyers. Individual investors were not encouraged to participate as the bonds were marketed in minimum denominations of $100,000. It is also our understanding that various brokerage firms will no longer sell Puerto Rico paper to individual investors without signed affirmation that they have read the risk factors as outlined in the Official Statement.

At RSW, our credit research is forward looking and seeks to avoid tomorrow's problems and challenges today. This explains why we have never loaned money to the Commonwealth of Puerto Rico, and for years have avoided the State of Illinois and most of its related issuers. At times, this could certainly limit the yield that our investors can earn, but from our perspective, principal preservation is tantamount and a cornerstone of our decision-making process.

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